DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 97-0542 ST

Sales/Use Tax — Cleaning Supplies
Sales/Use Tax — Software Licensing Agreements
Tax Administration — Penalty

For Tax Periods: 1994 through 1996

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ISSUES

I. Sales/Use Tax — Cleaning Supplies

Authority: IC 6-2.5-5-3(b); IC 6-2.5-5-5.1(b)
45 IAC 2.2-5-8(h); 45 IAC 2.2-5-12(f)
General Motors Corp. v. Indiana Department of State Revenue, 578 N.E.2d 399 (1991)
Department of State Revenue v. Chrome Deposit Corporation, 557 N.E.2d 1110 (Ind. 1991).

Taxpayer protests the proposed assessment of Indiana use tax on its purchase of cleaning supplies and materials.

II. Sales/Use Tax — Software Licensing Agreements

Authority: IC 6-2.5-2-1; IC 6-2.5-4-1; IC 6-2.5-4-10
45 IAC 2.2-4-2; 45 IAC 2.2-5-8(j)
Sales Tax Information Bulletin #8

Taxpayer protests the proposed assessment of Indiana use tax on its licensing of computer software.

III. Tax Administration — Penalty

Authority: IC 6-8.1-10-2; IC 6-8-10-2.1;
45 IAC 15-11-2; 45 IAC 2.2-3-20

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer, a retail merchant and commercial printer, produces and sells marketing materials, envelopes, cards, and other types of printed materials. Taxpayer also prints product labels for manufacturers and produces imprinted cartons for use as packaging. The majority of the time, taxpayer performs all design, manufacturing, and printing functions.

In conducting its business as a commercial printer, taxpayer has purchased cleaning supplies and computer software. Taxpayer neither paid sales tax nor self-assessed use tax on these items.

I. Sales/Use Tax — Cleaning Supplies

DISCUSSION

Taxpayer, a commercial printer engaged in manufacturing activities (see IC 6-2.5-5-3(a)(2)), protests Audit's assessment of use tax on its purchase of cleaning supplies.

According to Audit, taxpayer used its cleaning supplies to clean and maintain printing equipment. Normally, these cleaning activities occurred at the end of the workday. Occasionally, the printing presses were cleaned during production runs when ink color changes were necessary. From these observations, Audit concluded that taxpayer used its cleaning supplies exclusively for cleaning and maintenance activities - activities which, in Audit's opinion, clearly occurred outside taxpayer's production process. Consequently, Audit concluded that taxpayer could not invoke any of the industrial exemptions.

Audit considers taxpayer's cleaning of printing equipment to be a routine maintenance activity. As 45 IAC 2.2-5-8(h) states:

> Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

Additionally, because Audit characterizes most of taxpayer's cleaning to be post-production activity, Audit finds that the chemicals consumed in the cleaning of the printing equipment are taxable. 45 IAC 2.2-5-12(f) provides that:

> Purchases of materials consumed in manufacturing, processing, refining, or mining activities beyond the scope of those described in subsection B…are taxable. Such activities include post-production activities…

Taxpayer counters Audit's arguments by asserting that the cleaning supplies at issue - roller wash, blanket wash, nu blue, shop towels, and gloves - were directly used and consumed in the

direct production of commercial printing products. Consistent with the language of IC 6-2.5-5-3(b) and IC 6-2.5-5-5.1(b), taxpayer believes that these items should be exempt from Indiana sales and use tax.

IC 6-2.5-5-3(b) provides:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

IC 6-2.5-5-5.1(b) states in part:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing…. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing as described in IC 6-2.1-2-4.

The exemption statutes' "double direct" standard is met when the items used or consumed become "an essential and integral part of an integrated production process". *General Motors Corp. v. Indiana Department of State Revenue*, 578 N.E.2d 399 (1991). The following list is offered by taxpayer to show how essential and integral its cleaning activities are to the production process. Taxpayer notes the incidence and relevance of each activity:

(1) The printing blanket must be cleaned 10-12 times daily to prevent paper buildup.

(2) The machine - printing plate, printing blanket, and impression cylinder - must be cleaned during all jobs where an ink color change is required.

(3) The equipment must be cleaned whenever foreign objects are picked up during the printing process. These objects will erode the print quality and require the job to be redone.

(4) Plate cylinders must be cleaned after every job to prevent any ink buildup.

In addition to its statutory argument, taxpayer directs the Department's attention to *Department of State Revenue v. Chrome Deposit Corporation*, 557 N.E.2d 1110 (Ind.Tax 1990). In that case, the court held that cleaning supplies were exempt from Indiana sales and use tax pursuant to IC 6-2.5-5-3. *Id.* at 1118. Taxpayer contends that its position is analogous to that of Chrome Deposit, and similarly, taxpayer's cleaning supplies should enjoy exempt status.

The Department disagrees. Because the facts are dissimilar, the holding in *Chrome Deposit*, for this taxpayer, is inapposite.

Chrome Deposit manufactured layered hard chromium metal (a chromium sleeve) that was applied to customers' work rolls. Prior to application, the work rolls were "placed into a 'scrub tank' and physically scrubbed with sponges, water, and a special cleaning material that removed surface impurities." *Id*. The court held that "[t]hese cleansing items [were] an essential and integral part of the integrated process by which the hard chromium metal is produced and applied to the work rolls." *Id*. For these reasons, the court found that Chrome Deposit could take advantage of the industrial exemptions for its cleaning supplies. *Id*.

The court in *Chrome Deposit* did not find cleaning supplies exempt because they were used in cleaning activities, as there is nothing intrinsic in cleaning to transform supplies used - supplies normally taxable - into exempt items. Rather, the court found that because these particular cleaning activities were essential and integral to Chrome Deposit's integrated manufacturing process, the items used and consumed qualified for the industrial exemptions. When taxpayer invokes *Chrome Deposit* for the proposition that cleaning supplies are exempt from tax, taxpayer must also show that the cleaning activities in which the supplies are used are essential and integral to its production process.

Taxpayer has introduced evidence illustrating the diverse contexts in which the cleaning supplies are used. Taxpayer performs its cleaning activities at three times - during a particular job, between jobs, and at the end of the workday. The Department agrees with Audit's conclusion that cleaning performed between jobs and cleaning done at the end of the workday constitute routine maintenance activities. However, in the context of commercial printing, when taxpayer is required to engage in cleaning activities in order to finish a particular print job, such activities become essential and integral to taxpayer's production process.

Since the Department finds that cleaning performed during a particular job or production run is essential and integral to taxpayer's production process, materials used during those activities qualify for exemption under IC 6-2.5-5-3(b) and IC 6-2.5-5-5.1(b). However, when cleaning activities are performed between jobs, between production runs, or at the end of the workday, such use represents post-production maintenance activities. The materials used and consumed in those activities do not qualify for the industrial exemptions - consistent with the language of 45 IAC 2.2-5-8(h) and 45 IAC 2.2-5-12(f).

FINDING

Taxpayer's protest is sustained to the extent that cleaning supplies are used to clean printing equipment during a particular job. Taxpayer's protest is denied, however, when cleaning activities occur between jobs, between production runs, or at the end of the workday.

II. Sales/Use Tax — Software Licensing Agreements

DISCUSSION

Taxpayer protests the assessment of use tax on its licensing of computer software.

Taxpayer entered into a licensing agreement for computer software - software used exclusively for managerial and administrative purposes and not for production activities. Taxpayer did not pay sales or use tax on its acquisition of the software license.

Since taxpayer did not pay sales tax at the time of purchase, Audit assessed use tax on the cost to taxpayer of the software license. Audit determined that computer software used for management and administrative purposes was taxable pursuant to 45 IAC 2.2-5-8(j), which reads in part:

> Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax.

Taxpayer counters Audit's determinations with three arguments. First, taxpayer argues that the license of an intangible is not a transaction involving selling at retail. Consequently, the transaction cannot be taxed. Second, taxpayer contends that the opinion in *Lincoln National Life Insurance Company v. Department of State Revenue*, Ind. Cir. Ct., Noble County Docket No. C-80-635 (October 20, 1981), (holding that computer software is not tangible personal property), should serve as controlling authority. And third, taxpayer argues that this licensing agreement cannot be taxed because it represents the use of customized software. And customized software is not taxable.

In Indiana, sales tax is imposed on transactions of retail merchants which constitute selling at retail. One is engaged in selling at retail when one acquires tangible personal property and transfers it to another for consideration. (See IC 6-2.5-2-1(a) and IC 6-2.5-4-1(a).)

Taxpayer describes its software license as a "temporary limited license for the use of certain computer software." This acquisition does not meet the statutory definition of selling at retail, taxpayer reasons, because licenses are not tangible personal property. Furthermore, the item acquired for use - computer software - is not tangible personal property. Since application of Indiana sales and use tax is limited to tangible personal property, (absent specific statutory language to the contrary), taxpayer concludes that these intangibles cannot be taxed.

Next, taxpayer cites *Lincoln National* for the proposition that "the license of intangible and intellectual property does not fall within the scope of the Indiana sales tax statutes." In *Lincoln National*, the court held that:

> The computer program software licensed by Lincoln from IBM constituted intangible and intellectual property and not tangible personal property. [Therefore], IBM erroneously and illegally withheld and remitted sales tax on

> such transactions - [the sales of licensing agreements for computer software]. *Lincoln National* at 4.

Because its situation is similar to that of Lincoln National, taxpayer believes that its software license should also be exempt from Indiana sales and use tax.

And finally, taxpayer argues that the software licensing agreement should be exempt because it represents the licensing of *custom* software. Taxpayer refers to *Sales Tax Information Bulletin #8*, which states:

> Transactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program specifically designed for the purchaser.

Taxpayer contends that its software meets the definition of custom software because the software is (1) industry specific, (2) sold to only a small number of users (less than 200), (3) purchased as the result of extensive negotiations, and (4) not purchased "off-the-shelf." Additionally, the software required modification to accommodate taxpayer's particular needs. Taxpayer stresses that its software is neither similar nor analogous to taxable "canned" programs which generally are purchased off-the-shelf in shrink-wrapped packages.

The Department believes that a license or lease agreement of computer software is tantamount to the renting or leasing of tangible personal property - each represents a taxable event. (See IC 6-2.5-4-10(a)).

Additionally, even though computer software contains intellectual property, that classification, alone, is not sufficient to enable either the Department or taxpayer to conclude that software should be exempt from sales and use tax. As *Sales Tax Information Bulletin #8* informs:

> Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is not different than the intellectual property in a videotape or a textbook.

Taxpayer's reliance on *Lincoln National* is misplaced. *Lincoln National* is a nonappellate opinion. *Lincoln National* was decided in a county circuit court prior to the creation of the Indiana Tax Court. As such, it does not serve as precedent to suits brought outside the county in which it was originally brought.

The Department recognizes this software agreement entitles taxpayer to use industry specific software - software, taxpayer contends, which has been tailored to meet its specific needs. However, software can be tailored in many ways - ranging from the selection of setup, installation, and configuration options to actual modifications of source code.

It is axiomatic that industry specific software is not re-engineered for each individual licensee. At a minimum, there exists some quantum of source code that resides, initially, in every copy of

vendor's licensed software. This "core programming" is the equivalent of canned software, and is taxable.

However, the sale of custom software is not subject to tax in Indiana. Custom software represents a professional service rendered pursuant to 45 IAC 2.2-4-2. (Also see *Sales Tax Information Bulletin #8*). Modifications and additions to the original source code - changes made specifically for this taxpayer - represent custom programming services; and as such, are not taxable.

FINDING

To the extent taxpayer's software acquisition represents the purchase of canned software, taxpayer's protest is denied. To the extent taxpayer can show that the price of the software license represents coding modifications required to customize the software to meet taxpayer's specific requirements, this protest is sustained.

III. Tax Administration — Penalty

DISCUSSION

The taxpayer protests the imposition of the ten-percent (10%) negligence penalty.

The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

The Department finds that since taxpayer has shown reasonable cause, the negligence penalty should be waived.

FINDING

Taxpayer's protest is sustained.